In the Supreme Court
OF THE
United States

OCTOBER TERM, 1962

No. 270

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, a national banking association,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals for the Ninth Circuit

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO

Subject Index

	Page
Opinions below	1
Jurisdiction	2
Questions presented	2
Statutes and regulations involved	3
Statement of the case	4
Jurisdiction of court of first instance	4
Nature of the case	4
Reasons for granting the writ	9
Conclusion	11

Table of Authorities Cited

Cases

	Pages
Commissioner of Internal Revenue v. Mercantile National Bank at Dallas, 276 Fed. (2d) 58, affirming the Tax Court, 30 TC 84	4, 5, 8, 9, 10

Statutes

Internal Revenue Code of 1939:	
Sections 13, 22(b)(12), 430, 431	3
Section 22(a)	3, 10
Section 23	3, 10
Section 23(k)	3, 6, 8, 10, 11
Section 104	5
Sections 430 to 474	2
Section 433(a)	9
Section 433(a)(1)(G)	3, 8, 9, 11
Section 433(a)(1)(L)	3, 6, 7, 8, 9, 10

	Page
28 United States Code:	
Section 1254(1)	2
Section 1291	4
Section 1346(a)(1)	4

Miscellaneous

American Federal Tax Reports:	
Vol. 7 (2d), p. 685 (7 AFTR (2d) 685)	2
Vol. 9 (2d), p. 1519 (9 AFTR (2d) 1519)	2
Mimeograph 6209, 1947-2 Cum. Bul. 26	5
Revenue Ruling 54-74, Cum. Bul. 1954-1, p. 162 (1954)	6

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to the United States Court of Appeals for the Ninth Circuit

The Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above case on May 15, 1962.

OPINIONS BELOW

The opinion, findings of facts, conclusions of law, and judgment, of the U. S. District Court for the Northern

District of California, Southern Division, deciding in favor of the Petitioner herein, is printed in full on pages 37 to 43 of Volume 4 of the printed Transcript of Record (R.); and is reported in Volume 7 (2d), American Federal Tax Reports, p. 685 (7 AFTR (2d) 685). The opinion of the Court of Appeals for the Ninth Circuit reversing the District Court, is set forth in full in Appendix A hereof, and is reported at ___ F(2d) ___, also in Volume 9 (2d), American Federal Tax Reports, p. 1519 (9 AFTR (2d) 1519).

JURISDICTION

The judgment of the Court of Appeals was made and entered on May 15, 1962, (R. 99), and copy thereof, together with modification thereof by Court Order of June 18, 1962 to remand the case to the District Court to amend the judgment in conformity with the Court's opinion, is appended to this petition as Appendix B. A petition by petitioner herein for a rehearing was filed on June 6, 1962 (R. 100) and was denied on June 18, 1962 (R. 100). The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTIONS PRESENTED

The Excess Profits Tax Act of 1950 (Sections 430 to 474 of the Internal Revenue Code of 1939, hereinafter referred to as the Code), required that to compute excess profits net income, the normal-tax net income must be adjusted in the case of a bank using the reserve method of accounting for bad debts, to allow in lieu of the amount

allowable under the reserve method for bad debts, a deduction for debts which became worthless within the taxable year (Section 433(a)(1)(L) of the Code); and must also be adjusted to *exclude* income attributable to the recovery of a bad debt if the deduction for such debt was taken in a non-excess profits taxable year or if such debt was properly charged to a reserve for bad debts during such taxable year (Section 433(a)(1)(G) of the Code). The Questions Presented are:—

1. In computing the excess profits net income for a taxable year must a bank using the reserve method of accounting for bad debts reduce its deduction for worthless debts determined under Section 433(a)(1)(L) by the amount of recoveries credited to the bad debt reserve in that year.

2. In computing the normal-tax net income, which is to be adjusted to arrive at excess profits net income for a taxable year, must a taxpayer using the reserve method of accounting for bad debts include as income the bad debt recoveries credited to the bad debt reserve in that year.

3. Did the Court of Appeals exceed its authority in ignoring the Record and determining that there was error in matters which were not in issue and not a subject matter of the litigation.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

Sections 13, 22(a), 22(b)(12), 23, 23(k), 430, 431, 433(a)(1)(G) and 433(a)(1)(L). Pertinent parts of these

Statutes, and Regulations and Rulings thereunder, are set forth in Appendix C hereto.

STATEMENT OF THE CASE

Jurisdiction of Court of First Instance.

The plaintiff (petitioner herein), whose principal place of business is in San Francisco, California, within the judicial district of the United States District Court for the Northern District of California, Southern Division, brought this action in said Court for the recovery of Federal Income and Excess Profits taxes paid for the calendar years 1950, 1952 and 1953 imposed under the Internal Revenue Code of 1939 (Complaint para. 1-5 R3 & 4; Admitted Answer para. 1-5, R. 21 & 22). Jurisdiction was conferred on the District Court by 28 U.S.C. Section 1346(a)(1) (Stip. para. 1, R. 29).

The issue which was tried in said Court was tried entirely on the pleadings, a written stipulation of facts, and briefs (R. 29). The District Court decided in favor of the Plaintiff. The Government appealed to the Court of Appeals for the Ninth Circuit. Jurisdiction was conferred on the Court of Appeals by 28 U.S.C. Section 1291.

Nature of the Case.

In the hearing before the Court of Appeals, the Court's attention was called to the decision of the Court of Appeals for the Fifth Circuit in the case of *Commissioner of Internal Revenue v. Mercantile National Bank at Dallas*, 276 Fed. (2d) 58, affirming the Tax Court, 30 TC 84, a case which, excepting for figures, is identical with

this case. Government Counsel informed the Court that the Government was not following that decision and was litigating other cases involving the same issue as is involved in this case and in the *Mercantile National Bank* case. A copy of the Appellate Court decision in the *Mercantile National Bank* case is set forth in full in Appendix D hereto.

The Petitioner is a bank (as defined in Section 104 of the Code) (Stip. para. 2, R. 30). Commencing with 1944 the Petitioner used the reserve method of accounting for bad debts and in determining its annual additions to its reserve for bad debts it followed the provisions of Mimeograph 6209, 1947-2 Cum. Bul. 26 (Appendix C hereto; Stip. para. 8, R. 31), a special ruling relating to the computation of bad debt deductions for banks using the reserve method.

Under this reserve method, the reserve for bad debts was credited for the amount taken out of income and added to the reserve, and also was credited for recoveries on bad debts which, when determined to be worthless, had been charged against said reserve; and the reserve was charged with the amount of debts determined to be worthless (Stip. para. 8, R. 31).

In the income and excess profits tax returns filed by the Petitioner for the years 1950, 1951, 1952 and 1953 the Petitioner took, and the Commissioner of Internal Revenue (hereinafter referred to as Commissioner) al-

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[1]Although Petitioner paid no excess profits tax for 1951, the excess of the excess profits credit for that year over the excess profits net income is a carry-back credit which offsets the excess profits tax for the year 1950.

lowed, as a deduction under Section 23(k) of the Code in computing the normal-tax net income for the respective years, the amount of its addition to the reserve taken out of income. (Stip. para. 11, R. 32).

The recoveries of debts previously charged to the reserve and which recoveries were credited to the reserve in the taxable years here involved, were not included or reported as income on the petitioner's tax returns in computing normal-tax net income for said years. (Stip. para. 9, R. 31, Returns R.-Vol 2).

In the excess profits tax schedule of the tax returns for said years Petitioner took as a deduction for bad debts the amount of debts determined to be worthless in the respective years in lieu of the amount which it had deducted for bad debts in computing normal-tax net income for said years. (Stip. para. 10, R. 32, Returns R.-Vol 2).

The Commissioner audited these tax returns and recomputed the Petitioner's normal-tax net income for each of the years involved and also the excess profits net income for each of said years. In his audit the Commissioner made certain changes including an adjustment of the bad debt deduction taken by the Petitioner on its returns under Section 433(a)(1)(L) by reducing it by the total recoveries credited to the bad debt reserve in the respective taxable years, and he took this action pursuant to a Revenue Ruling known as Revenue Ruling 54-74, Cum. Bul. 1954-1, p162, issued in 1954 and set forth in full in Appendix C hereto. (Stip. para. 12, 13, R. 32, 34).

The Petitioner took no exception to any of the audit changes except the adjustment of the bad debt deductions

(Complaint R. 3-21). In its complaint the Petitioner alleged the amount of its normal tax net income to be the amount determined by the Commissioner in his audit, and it was admitted in the Government's answer to the complaint. Likewise, the Petitioner alleged the amount of its excess profits net income as determined by the Commissioner and alleged also that in arriving at this net income the Commissioner had reduced the bad debt deduction by the bad debt recoveries, which allegations were admitted in the Answer. The Petitioner then complained of the Commissioner's action in reducing its bad debt deduction. (Complaint R. 3-21)

In the Joint Pre-trial Memorandum filed with the District Court[2] the issue was stated to be "whether in computing the deduction for bad debts for excess profits tax purposes the plaintiff must reduce the amount of debts which become worthless during an excess profits taxable year by the amount of recoveries in that year of debts determined to be worthless in previous years, which recoveries had been credited by the taxpayer on its books to its bad debt reserve account."

Upon the Record the District Court made its Findings of Fact (R. 9) and concluded as a matter of law that "under Section 433(a)(1)(L) of the Internal Revenue Code of 1939 the plaintiff is entitled in each of the years 1950, 1951, 1952 and 1953, to a bad debt deduction for excess profits tax purposes in the amount stipulated as

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[2]Referred to in index of Printed Record though not printed, but is part of the Record before the Court of Appeals and transmitted to this Court.

the amount of the debts which became worthless within the respective taxable years, and such amount is not to be reduced by bad debt recoveries credited in the respective years to the bad debt reserve account." (R. 40). In its Order for judgment the District Court called attention to the similarity of this case and the case of *Commissioner v. Mercantile National Bank at Dallas*, 276 F(2d) 58, and stated, "The arguments advanced by the Government here do not detract from the sound reasoning which led the Court of Appeals for the 5th Circuit to uphold the Tax Court in Mercantile. This Court adopts the opinion of Judge Jones in Mercantile and accordingly grants judgment for the plaintiff in the instant action." (R. 37-38).

The Court of Appeals in reversing the District Court held (1) that the Commissioner was authorized by Section 433(a)(1)(G) of the Code to *include* in excess profits net income all the recoveries credited to the reserve for bad debts in the taxable years, (2) that the recoveries credited to the reserve should have been included in normal-tax net income under authority of Section 433(a)(1)(G) *(which relates only to an exclusion)* and Section 23(k) *(which relates only to a deduction from gross income)*, and regulations thereunder, and, (3) that by virtue of the authorizations contained in these sections the Commissioner was correct in reducing the worthless debts by the recoveries in arriving at the allowable deduction for bad debts under Section 433(a)(1)(L). The Court, recognizing that its decision was in conflict with the decision of the Fifth Circuit in the *Mercantile National Bank at Dallas* case, specifically refused to follow that decision.

REASONS FOR GRANTING THE WRIT

1. The decision below should be reviewed because it is in direct conflict with the decision of the Court of Appeals for the Fifth Circuit in the case of *Commissioner of Internal Revenue v. Mercantile National Bank at Dallas* (1961) 276 F(2d) 58. Excepting for figures, that case is identical in facts, issue, and legal questions involved, with this case. The Court of Appeals for the Fifth Circuit affirming the Tax Court of the United States, 30 TC 84, pointed out that bad debt recoveries by a taxpayer using the reserve method of accounting for bad debts are not includible in normal tax net income, and held that (1) Section 433(a)(1)(L) neither authorizes the reduction of the bad debt deduction by recoveries credited to the reserve, nor does it authorize the inclusion of such recoveries in excess profits income, and (2) neither Section 433(a)(1)(G) nor any other provision of Section 433(a) provides for the inclusion of such recoveries or any part thereof in excess profits net income. Both the Tax Court and the Court of Appeals made a careful and extensive analysis of the Statute involved in arriving at this conclusion.

The Court of Appeals for the Ninth Circuit, in its opinion herein, recognizes that its decision conflicts with the decision in the *Mercantile National Bank at Dallas* case. It specifically mentions in its decision that it disagrees with the conclusions reached by the Fifth Circuit, and refuses to follow it.

2. During the course of the argument before the Court below Government counsel stated that there were several other cases similar to this one pending in other Circuits.

and the Government considered the cases, and the legal questions involved, important enough to continue to prosecute them notwithstanding the adverse decision in the *Mercantile National Bank at Dallas* case. In view of the Government's representation as to the importance of the question of federal law involved whether bad debt recoveries by a taxpayer using the reserve method for bad debts must be included in excess profits tax income either directly, or indirectly by reduction of the bad debt deduction specifically allowed by Section 433(a)(1)(L), this question, which has not been decided by this Court, should be settled by this Court.

3. Further, the decision of the Court below to the effect that the bad debt recoveries by a taxpayer on the reserve method, must be included in normal-tax income is so far reaching, and so contrary to the pattern, design and concept of the income tax law, that, unless reviewed by this Court, it will be a dangerous authority for an ambiguous if not erroneous construction of the tax law which can lead only to confusion and controversy.

The statement by the Court below that Section 23(k) and Regulations thereunder *authorize the inclusion of recoveries credited to the reserve, in normal-tax income*, completely overlooks the concept of the tax law whereunder items includible in gross income are specified in Section 22(a), and items which are allowable as deductions from gross income to arrive at net income on which the normal tax is based, are specified in Section 23. Section 23(k) provides only that a *deduction* is to be allowed for bad debts. *Section 23(k) does not authorize the inclusion of anything in gross income.* There is no provision

in the law for the inclusion in income of recoveries credited to the bad debt reserve by a taxpayer using the reserve method for bad debts.

This question of whether such recoveries are includible in gross income, and whether Section 23(k) authorizes such a conclusion, as decided by the Court below, is so important a question of federal law that this Court should settle it.

4. The action of the Court below in ignoring the record in the case and rendering a decision on the points as to (1) whether the bad debt recoveries credited to the reserve are includible in normal-tax net income, and (2) whether Section 433(a)(1)(G) is *authority for inclusion* of recoveries in excess profits tax income, which were never a matter of issue in the litigation, is such a departure from the accepted and usual course of judicial proceeding as to call for an exercise of this Court's power of supervision.

CONCLUSION

For the reasons set forth above it is respectfully submitted that this petition for a writ of certiorari should be granted.

Dated, San Francisco, California,
July 16, 1962.

Respectfully submitted,

GEORGE H. KOSTER,
Attorney for Petitioner.

(Appendices A, B, C and D Follow.)

Appendix A

United States Court of Appeals
for the Ninth Circuit

United States of America, *Appellant*, vs. Bank of America National Trust and Savings Association, a national banking association, *Appellee*.	No. 17,412 May 15, 1962

Appeal from the United States District Court for the Northern District of California Southern Division

Before: HAMLEY and KOELSCH, Circuit Judges, and MURRAY, District Judge

HAMLEY, Circuit Judge:

This appeal involves federal excess profits taxes for the years 1950, 1952 and 1953 in the aggregate amount of $1,510,803.54. Deficiencies aggregating this sum were assessed and paid. Timely claims for refunds were filed and were rejected. The taxpayer then brought this action for recovery of the taxes paid. The district court granted judgment for plaintiff, the exact amount of recovery being computed by the Internal Revenue Service pursuant to the stipulation of the parties. The United States appeals.

Taxpayer is a national bank which used the reserve method of accounting for bad debts during the taxable years in question. Section 433(a)(1)(L) of the Internal Revenue Code of 1939 relating to the computation of excess profits net income, provides that in the case of such a bank using the reserve method of accounting for bad debts, there shall be allowed, in lieu of the amount allowable under the reserve method for bad debts, a deduction for debts which became worthless within the taxable year, in whole or in part, within the meaning of section 23(k) of the Internal Revenue Code of 1939.

Giving effect to its construction of section 433(a)(1)(L), the taxpayer reported on line 19 of its excess profits tax form for each of those years (Schedule EP, Form 1120), the amount of debts determined to be worthless during such year, without reduction by the amount of recoveries or collections of debts previously charged off. The Commissioner, in keeping with Revenue Ruling 54-74, 1954-1 Cum. Bull. 162, made these reductions and assessed tax deficiencies resulting therefrom. In Revenue Ruling 54-74 it was stated, in effect, that such reductions were required by section 433(a)(1)(G) of the Internal Revenue Code of 1939.

The question presented is whether, in these circumstances, the taxpayer is required to reduce its deduction for bad debts which became worthless during the taxable year by the amount of recoveries of bad debts deducted as worthless in prior excess profits tax years.

The answer to this question calls for a construction of subparagraphs (G) and (L) of section 433(a)(1), re-

lating to bad debt recoveries and deductions in computing excess profits net income. These subparagraphs prescribe adjustments to be made in normal-tax net income in order to arrive at excess profits net income.[1] We therefore turn first to a consideration of the manner in which bad debt recoveries and deductions were treated in computing normal-tax net income.

Under sections 22(b)(12) and 23(k) of the 1939 Code, bad debt recoveries and deductions could be accounted for in either of two ways. One of these was for the taxpayer to add to gross income the amount of any recoveries received on bad debts which had been deducted from gross income in prior years and which produced a reduction in tax for such years, and claim as a deduction from gross

[1] This is indicated by the context in which subparagraphs (G) and (L) appear, which is as follows:

"433. Excess profits net income

(a) Taxable years ending after June 30, 1950. The excess profits net income for any taxable year ending after June 30, 1950, shall be the normal-tax net income, as defined in section 13(a)(2) for such year increased or decreased by the following adjustments:

(1) Adjustments.

(G) Recoveries of bad debts. There shall be excluded income attributable to the recovery of a bad debt if the deduction of such debt was allowable from gross income for any taxable year beginning before January 1, 1940, or beginning after December 31, 1945, and ending before July 1, 1950, or if such debt was properly charged to a reserve for bad debts during any such taxable year;

(L) Bad debts in case of banks. In the case of a bank (as defined in section 104) using the reserve method of accounting for bad debts, there shall be allowed, in lieu of the amount allowable under the reserve method for bad debts, a deduction for debts which became worthless within the taxable year, in whole or in part, within the meaning of section 23(k);"

income the amount of bad debts which became worthless during the particular tax year.[2]

The other way of accounting for bad debt recoveries and deductions in computing normal-tax net income was for the taxpayer to use the reserve method of accounting for bad debts. Under this method, the taxpayer was allowed to deduct from gross income a reasonable addition to the reserve instead of the amount of bad debts which actually became worthless during the taxable year. Debts which became worthless were charged to the reserve and the reserve was credited with the amount of recoveries received on debts previously charged to the reserve. Thus, for purposes of computing normal-tax net income, the bad debt reserve reflected the amount of bad debt recoveries, because crediting them to the reserve reduced the amount of the reasonable addition otherwise allowable as a deduction.[3]

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[2]See *Burnett v. Sanford & Brooks Co.*, 282 U.S. 359; *National Bank of Commerce v. Commissioner*, 9 Cir., 115 F.2d 875. Instead of adding the recoveries to gross income, the taxpayer could achieve the same result by reducing his bad debt losses by the amount of such recoveries.

[3]Beginning with the year 1944, appellee used the reserve method of accounting for bad debts. In determining its annual additions to its reserve for bad debts, appellee followed the provisions of Mimeograph 6209, 1947-2 Cum. Bull. 26. Paragraph 6 thereof provides that bad debt losses sustained are to be charged to the reserve, "and recoveries made of specific debts which have been previously charged against the reserve by a bank on the reserve method of treating bad debts should be credited to the reserve." Thus, in computing its normal-tax net income appellee, along with all other banks using the reserve method of accounting for bad debts, in effect added to gross income recoveries of bad debts which had produced a reduction in taxes for previous years. Compare *Zellerbach Paper Co. v. Commissioner*, 8 T.C. 511; *Boyd-Richardson Co. v. Commissioner*, 5 T.C. 695; *J. F. Johnson Lumber Co. v. Commissioner*, 3 T.C. 1160.

We turn now to the adjustments for bad debt recoveries and deductions prescribed in subparagraphs (G) and (L) of section 433(a)(1). Subparagraph (G) pertains to the adjustment to be made in the manner of accounting for bad debt recoveries. Examination of this subparagraph, quoted in note 1 above, indicates that it applies to all taxpayers, including banks, and to those who account for bad debt recoveries by the reserve method as well as those who do not.

With regard to all taxpayers, subparagraph (G) excludes from income attributable to the recovery of bad debts, as such income would be computed in determining normal-tax net income, the portion thereof which is attributable to bad debts which were allowed as deductions, or as charges to a reserve for bad debts, in a *non*-excess profits tax year.

The bad debt recoveries here in issue are not attributable to any bad debts which were allowed as deductions, or as charges to a reserve for bad debts, in a non-excess profits tax year. It follows that, not being excluded under paragraph (G), such recoveries, being included in computing normal-tax net income, are likewise included in computing excess profits net income.

The adjustment delineated in subparagraph (L) of section 433(a)(1), provides some relief for banks with regard to bad debt deductions but no relief with regard to bad debt recoveries. This is indicated by the language of the subparagraph quoted in note 1 above. That subparagraph contains no language constituting an exception, in the case of banks, as to the method of accounting for bad

debt recoveries. It does make express reference to section 23(k) of the 1939 Code. That section and the regulations issued thereunder have consistently provided that recoveries of bad debts previously charged off must be included in gross income when received.[4]

The legislative history of subparagraph (L) also indicates that it was not intended to afford banks any relief with respect to bad debt recoveries, but was only designed to somewhat equalize their position with that of other taxpayers, including banks not using the reserve method, in reflecting bad debt deductions in their excess profits tax returns.

Where the reserve method of accounting for bad debt recoveries and deductions is used, a limitation is placed on the total amount of reserves for which bad debt deductions may be claimed.[5] But the House and Senate Com-

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[4] See Article 151 of Treasury Regulations 62, 65 and 69, promulgated under the Revenue Acts of 1921, 1924 and 1926, Article 191 of Treasury Regulations 74 and 77, promulgated under the Revenue Acts of 1928 and 1932, Article 23(k)-1 of Treasury Regulations 86, 94 and 101, promulgated under the Revenue Acts of 1934, 1936 and 1938, and Sections 19.23(k)-1, 29.23(k)-1 and 39.23(k)-1 of Treasury Regulations 103, 111 and 118, promulgated under the Internal Revenue Code of 1939. Thus, sections 29.23(k)-1 of Treasury Regulations 111 and 118 provide, in pertinent part:

". . . Any amount subsequently received on account of a bad debt or on account of a part of such debt previously allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received, except to the extent excludible from gross income under the provisions of section 22(b)(12). . . ."

[5] In the case of banks, this limitation is prescribed in Mimeograph 6209, 1947-2 Cum. Bull. 26. By prescribing a limitation on the total amount of the reserve, the same result is reached with regard to accounting for bad debt recoveries as where the reserve method is not used. Where the reserve method is not used, such recoveries are added to gross income. Where the reserve method

mittees considering the bill which became the Excess Profits Tax Act of 1950 realized that banks using the reserve method might not be able to claim a large enough deduction for excess profits tax purposes, since their accumulated reserves already approached the maximum allowable. In order to afford these banks some measure of relief, the committees therefore determined that banks would be allowed a deduction of the amount of the debts which actually became worthless, instead of the limited, or possibly non-existent, additions to the reserve to which they might otherwise be entitled.[6]

There is nothing whatever in the legislative history of subparagraph (L), or of any other provision of the 1950 Act, which indicates that (L) was designed to affect, in any way, the method of accounting for bad debt re-

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is used, the reserve is credited with the amount of bad debt recoveries. But when the reserve reaches the prescribed limit on the total amount of the reserve, deductions from taxable income, for the purpose of crediting the reserve, must cease until the reserve is again reduced.

[6] See S.Rep. No. 2679, 81st Cong., 2nd Sess., p. 15 (1951-1 Cum. Bull. 240, 250); H.Rep. No. 3142, 81st Cong., 2nd Sess., p. 14 (1951-1 Cum. Bull. 187, 196). In the House Committee report it is stated, at page 14:

> "For income tax purposes, banks have been permitted to use the reserve method of accounting for bad debts. The banks which elected to use this method, beginning in 1947, have for the most part accumulated reserves which equal or approach the maximum allowable under the existing rulings. The fact that the reserves have reached or approached the allowable maximum, plus the probability that losses from bad debts will be abnormally low during the excess profits tax years, means that the deduction in the excess profits tax period will be comparatively low. To permit an equitable comparison between the base-period net income and the income of the excess profits tax years, the bill permits banks using the reserve method of accounting for bad debts to claim a deduction for the purpose of determining excess profits tax net income on the basis of debts which became worthless in whole or in part during the taxable year."

coveries, as set forth in subparagraph (G) of section 433(a)(1).

But while subparagraph (L) does not pertain to bad debt recoveries, the Commissioner chose to have the returns of banks using the reserve method reflect inclusions in income of bad debt recoveries, by requiring that they be taken into account in computing deductions for bad debts under paragraph (L), rather than by including such recoveries under gross income. This is the purport of Revenue Ruling 54-74, referred to above. It was accomplished simply by requiring that the deduction for bad debts which became worthless in the respective years be reduced by the amounts of recoveries of bad debts which had been credited to the reserve in prior excess profits tax years. That is what appellee failed to do in this case, and what the Commissioner did in recomputing appellee's excess profits taxes.

The fact that the Commissioner thus chose to have such income and such deductions accounted for in one step, in computing deductions for bad debts under subparagraph (L), rather than in the indicated two steps, has not prejudiced the taxpayer. The results would be the same under either method of accounting.

In reaching a different conclusion the district court relied upon *Commissioner v. Mercantile National Bank at Dallas*, 5 Cir., 276 F.2d 58, where the identical problem was presented. The court there held, in effect, that since subparagraph (L) did not provide that the deduction for bad debts thereby authorized was to be reduced by bad debt recoveries of the kind here in question, there was no statutory warrant for doing so.

In our view, this reasoning overlooks the fact that the reduction for bad debt recoveries required under Revenue Ruling 54-74 finds its authority not in subparagraph (L), but in paragraph (a) and subparagraph (G).

In the above-cited case, at page 60, it is stated that neither in subparagraph (L) "nor elsewhere in section 433(a) did Congress provide for the inclusion by such banks of recoveries of bad debts." We are unable to agree with this conclusion.

The opening paragraph of section 433(a) quoted in footnote 1, expressly provides for the inclusion by all taxpayers (including banks) in excess profits net income of all normal-tax net income which, as indicated above, would include these bad debt recoveries, subject only to the adjustments provided for in section 433(a)(1). As previously pointed out, the bad debt recoveries here in issue are not excluded by any of the adjustments so prescribed.

In the *Mercantile National Bank* case, it is also stated, at page 62, that subparagraph (G) "considered in context, relates to taxpayers who do not use the bad debt reserve method of accounting and so are required to include bad debt recoveries in the computation of normal tax income." We respectfully disagree with this conclusion for two reasons: first, *all* taxpayers, not just those who use the specific charge-off method of accounting for bad debts, are required to reflect bad debt recoveries in the computation of their normal-tax income; second, subparagraph (G) is applicable to taxpayers on the reserve method, for it is expressly provided in that section that certain recoveries may be excluded from excess-profit in-

come ". . . if such debt was properly charged to a reserve for bad debts during any such taxable year: . . ."

If the Excess Profits Tax Act of 1950 is given the construction for which appellee contends, all non-bank taxpayers, and all bank taxpayers which account for bad debt recoveries and deductions by a non-reserve method, must account for bad debt recoveries of the kind here in issue, while banks using the reserve method are excused from such a requirement. In our opinion, neither the language of the act nor the legislative history warrants such a result.

The judgment is reversed.

(Endorsed) Opinion Filed May 15, 1962.

Frank H. Schmid, Clerk.

Appendix B

United States Court of Appeals
for the Ninth Circuit

United States of America, *Appellant*, vs. Bank of America National Trust and Savings Association, a national banking association, *Appellee*.	No. 17,412

JUDGMENT

Appeal from the United States District Court
for the Northern District of California

This Cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is reversed and that this cause be and hereby is remanded to the said District Court with directions to amend the judgment in conformity with the opinion of this Court.

Filed and entered May 15, 1962 as amended by order of June 18, 1962.

United States Court of Appeals
for the Ninth Circuit

United States of America, *Appellant*; vs. Bank of America National Trust and Savings Association, a national banking association, *Appellee*.	No. 17,412 ORDER

ON PETITION FOR REHEARING

Before: HAMLEY and KOELSCH, Circuit Judges and MURRAY, District Judge

The last paragraph of the opinion filed herein on May 15, 1962, is amended to read:

> "The judgment is reversed and the cause is remanded with directions to amend the judgment in conformity with this opinion."

The petition for rehearing is denied.

/s/ Frederick G. Hamley
/s/ M. Oliver Koelsch
Circuit Judges
/s/ William D. Murray
District Judge

(Endorsed) Filed June 18, 1962.

Frank H. Schmid, Clerk.

Appendix C

STATUTES, REGULATIONS, RULINGS AND CONGRESSIONAL REPORT

Internal Revenue Code of 1939: (Title 26 U.S.C. 1952 ed.)

Chapter 1, Subchapter B. Part I:

SEC. 13. NORMAL TAX ON CORPORATIONS.

(a) *Definitions.*—For the purpose of this chapter—

(1) Adjusted net income.—The term "adjusted net income" means the net income minus the credit provided in section 26(a), relating to interest on certain obligations of the United States and Government corporations.

(2) Normal-tax net income.—The term "normal-tax net income" means the adjusted net income minus the sum of the following credits:

(A) The credit for dividends received provided in Section 26(b);

(B) In the case of a public utility, the credit for dividends paid on its preferred stock provided in Section 26(h); and

(C) In the case of a western hemisphere trade corporation (as defined in section 109), the credit provided in section 26(i).

Chapter 1, Subchapter B. Part II—Computation of Net Income.

SEC. 21. NET INCOME.

(a) *Definition.*—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

(b) *Cross References.*—For definition of "adjusted net income" and "normal-tax net income", see section 13.

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal services . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . .

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

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(12) [as added by Section 116(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Recovery of bad debts, prior taxes, and delinquent amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

* * * * *

(D) *Definition of recovery exclusion.*—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner with

the approval of Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102), or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

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SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(k) [as amended by Section 113(a), Revenue Act of 1943, c. 63, 57 Stat. 126] *Bad Debts.*

(1) *General rule.*—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. * * *

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Chapter 1, Subchapter D. Part I:

SEC. 430 [as added by Section 101, Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137] IMPOSITION OF TAX.

(a) *General Rule.*—In addition to other taxes imposed by this chapter, there shall be levied, collected, and paid for each taxable year ending after June 30, 1950, and beginning before July 1, 1953, upon the adjusted excess profits net income, as defined in sec-

tion 431, of every corporation (except a corporation exempt under section 454) an excess profits tax equal to whichever of the following amounts is the lesser:

* * * * *

SEC. 433 [as added by Section 101, Excess Profits Tax Act of 1950, *supra*]. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Ending After June 30, 1950.* The excess profits net income for any taxable year ending after June 30, 1950, shall be the normal-tax net income, as defined in section 13(a)(2), for such year increased or decreased by the following adjustments:

(1) *Adjustments.*—

* * * * *

(G) *Recoveries of bad debts.*—There shall be excluded income attributable to the recovery of a bad debt if the deduction of such debt was allowable from gross income for any taxable year beginning before January 1, 1940, or beginning after December 31, 1945, and ending before July 1, 1950, or if such debt was properly charged to a reserve for bad debts during any such taxable year;

* * * * *

(I) *Bad debts in case of banks.*—In the case of a bank (as defined in section 104) using the reserve method of accounting for bad debts, there shall be allowed, in lieu of the amount allowable under the reserve method for bad debts, a deduction for debts which became worthless within the taxable year, in whole or in part, within the meaning of section 23(k);

Treasury Regulations:

Regulation 118: Income Taxes

Sec. 39.22(b)(12)-1 *Recovery of certain items previously deducted.*

(a) *In general.* Section 22(b)(12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to any other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. See Dobson v. Commissioner, 320 U.S. 489. The term "recovery exclusion" as used in this section means accordingly an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 22(b)(12)), and all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under chapter 1 of the Internal Revenue Code (other than a tax under section 102), or under corresponding provisions of prior revenue laws.

(1) *Section 22(b)(12) items.* The term "section 22(b)(12) items" as used in this section means those bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against

a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 22(b)(12) item.

Sec. 39.23(k)-1 *Bad debts.* (a) Bad debts may be treated in either of two ways—

(1) By a deduction from income in respect of debts which become worthless in whole or in part, or

(2) By a deduction from income of an addition to a reserve for bad debts.

. . . . . .

(c) If, from all the surrounding and attending circumstances, the Commissioner is satisfied that a debt is partially worthless, the amount which has become worthless, to the extent charged off during the taxable year, shall be allowed as a deduction in computing net income. If a taxpayer claims a deduction for a part of a debt for the taxable year within which such part of the debt is charged off and such deduction is disallowed for such year and the debt becomes partially worthless subsequent to such year, a deduction may be allowed for a subsequent taxable year, not in excess of the amount charged off in the prior year plus any amount charged off in the subsequent year, the charge-off in the prior year, if consistently maintained as such, being sufficient to that extent to meet the charge-off requirement. Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the Commissioner the amount thereof which is uncollectible and the part thereof which was charged off. If a debt becomes wholly worthless during the taxable year, the amount thereof which has not been allowed as a deduction for any prior taxable year shall be allowed as a deduction for the taxable year. There should accom-

panny the return a statement of facts substantiating any deduction claimed for bad debts. Any amount subsequently received on account of a bad debt or on account of a part of such debt previously allowed as a deduction for income tax purposes must be included in gross income for the taxable year in which received, except to the extent excludable from gross income under the provisions of section 22(b)(12). In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only.

39.23(k)-5. *Reserve for bad debts.* (a) *Taxpayer other than mutual savings banks, building and loan associations, and cooperative banks.* (1) Taxpayers who have established the reserve method of treating bad debts and maintained proper reserve accounts for bad debts, or who, in accordance with Sec. 39.23(k)(1), adopt the reserve method of treating bad debts, may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of a deduction for specific bad debt items.

(2) What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, those arising in prior taxable years, and the total amount of the existing reserve. In case subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the

excess or inadequacy in the existing reserve should be reflected in the determination of the reasonable addition necessary in the taxable year. A taxpayer using the reserve method should make a statement in his return showing the volume of his charge sales (or other business transactions) for the year and the percentage of the reserve to such amount, the total amount of notes and accounts receivable at the beginning and close of the taxable year, and the amount of the debts which have become wholly or partially worthless and have been charged against the reserve account.

Regulations 130:—Excess Profits Tax

Sec. 40.433(a)—1. Excess profits net income for the taxable year.—The excess profits net income computed under section 433(a), for any taxable year ending after June 30, 1950, is the normal-tax income increased or decreased by the adjustments provided in section 433(a)(1).

Sec. 40.433(a)-2. Computation of excess profits net income for the taxable years.

(g) The provisions of section 433(a)(1)(G) require the exclusion from excess profits net income of any income attributable to the recovery of a bad debt, if either (1) a deduction from gross income was allowable with reference to such debt for any taxable year for which an excess profits tax was not imposed (that is, a taxable year beginning before January 1, 1940, or a taxable year beginning after December 31, 1945, and ending before July 1, 1950), or (2) if such debt was properly charged to a bad debt reserve during any such taxable year. For example, if a deduction of $10,000 from gross income would have been allowable for an addition to the reserve account in the

absence of bad debts recovered which had been charged against the reserve account for the year 1948, and if no deduction is required for the taxable year by reason of such bad debts recovered, in the amount of $13,000 and credited to the reserve account, the adjustment of the normal-tax net income for the taxable year under section 433(a)(1)(C) would be limited to $10,000. In such case, the excess of the bad debt recoveries over the amount which would have been added to the reserve account had there been no such recoveries, i.e., the $3,000, will decrease the amount to be added to the reserve the following year, and accordingly such amount may be excluded under section 433(a)(1)(C) in such following years.

Section 40.433(a)-2

(1) In the case of a bank (as defined in section 104) using the reserve method of accounting for bad debts, section 433(a)(1)(A) requires an adjustment to normal-tax net income equal to the difference between (1) the amount of the deduction for additions to the reserve for bad debts allowed under section 23(k) (including, in the case of the taxable year in which the reserve is established, the deduction for the initial credit to the reserve) and (2) the amount that would have been allowable as a deduction under section 23(k) for bad debts for the taxable year if the bank did not use the reserve method of accounting for bad debts. The adjustment is effected by increasing normal-tax net income by the amount of the deduction allowed under section 23(k) for the additions to the bad debt reserve for the taxable year and by decreasing normal-tax net income by the amount of the deduction which would be allowable under section 23(k) for the debts which actually became worthless in the taxable year, in whole or in part.

Internal Revenue Service Ruling:

Rev. Rul. 54-74, 1954-1 Cum. Bull. 162:

Advice is requested with respect to the proper treatment, for excess-profits tax purposes, to be accorded recoveries of bad debts in the case of banks using the reserve method of accounting for bad debts.

Section 433(a)(1)(G) of the Internal Revenue Code provides for the exclusion from excess-profits net income of any income attributable to the recovery of a bad debt if the deduction for such debt was allowable from gross income for any taxable year for which an excess-profits tax was not imposed (that is, a taxable year beginning before January 1, 1940, or a taxable year beginning after December 31, 1945, and ending before July 1, 1950), or if such debt was properly charged to a bad debt reserve during any such taxable year. Under section 433(a)(1)(L) of the Code, banks which have elected the reserve method of accounting for bad debts for income tax purposes should substitute for excess-profits tax purposes a deduction for bad debts which actually become worthless in the taxable year.

Line 19, page 1, of Schedule EP (Form 1120), for the taxable years 1952 and 1953 should reflect the excess, if any, of the actual bad debts for the taxable year over the total recoveries of bad debts during such taxable year. If such recoveries exceed such actual bad debts, line 19 should show such excess as an addition, preferably in red ink. Line 16 of the returns should reflect only those recoveries which should be excluded under section 433(a)(1)(G) of the Code. Since, for excess-profits tax purposes, banks are on the specific charge-off method for treating bad debts, no adjustment on line 5 of Schedule EP (Form 1120) will be necessary where the ceiling is reached

and no addition to the reserve is permissible for income tax purposes under the provisions of Mimeograph 6209, C.B. 1947-2, 26.

Mimeograph 6209, Cum. Bul. 1947-2, p. 26:

This ruling after describing a method of computing a reasonable annual addition to a reserve for bad debts which would be a permissible method for a bank, states:

"6. Bad debt losses sustained are to be charged to the reserve, and recoveries made of specific debts which have been previously charged against the reserve by a bank on the reserve method of treating bad debts should be credited to the reserve."

Congressional Committee Reports:

A. Referring to enactment of Section 22(b)(12) hereinbefore quoted:

Senate Finance Committee Report 1631, 77th Congress Second Session—October, 1942 Cum. Bul. 1942-2, p. 504 at 565:

"The amendments made by this subsection do not apply to recoveries on account of bad debts previously charged or chargeable against a reserve by a taxpayer on the reserve method of treating bad debts, inasmuch as the amount of such recoveries is not taken into income as such but is merely credited to the reserve which has previously been taken as a deduction in lieu of a deduction for specific bad debt items."

B. Referring to Section 433(a)(1)(G):

HR. Report No. 3142, 81st Congress Second Session, Cum. Bul. 1951-1, p. 187 at 195:

"This bill, like the World War II law, excludes certain types of sporadic income, such as—

2. Income arising from the recovery of bad debts in cases where no deduction has been claimed in a year for which an excess profits tax was imposed under the World War II law or would be imposed under this bill; . . ."

S. Report No. 2679, 81st Congress Second Session, Cum. Bul. 1951-1, p. 240 at 248:

"Like the World War II law, the committee's bill excludes certain other types of sporadic income, such as—

2. Income arising from the recovery of bad debts in cases where no deduction has been claimed in a year for which an excess profits tax was imposed under the World War II law or would be imposed under this bill; . . ."

C. Referring to Section 433(a)(1)(L):

H.R. Rep. No. 3142, 81st Cong. 2nd Session, p. 14, Cum. Bul. 1951-1, p. 187 at 196:

"For income tax purposes, banks have been permitted to use the reserve method of accounting for bad debts. The banks which elected to use this method, beginning in 1947, have for the most part accumulated reserves which equal or approach the maximum allowable under the existing rulings. The fact that the reserves have reached or approached the allowable maximum, plus the probability that losses from bad debts will be abnormally low during the excess profits tax years, means that the deduction in the excess profits tax period will be comparatively low. To permit an equitable comparison between the base-period net income and the income of the excess profits tax years, the bill permits banks using the reserve method of accounting for bad debts to claim

a deduction for the purpose of determining excess profits tax net income on the basis of debts which become worthless in whole or in part during the taxable year."

S. Rep. No. 2679, 81st Cong. 2nd Session, p. 15, Cum. Bul. 1951-1, p. 240 at 250:

"Banks which have elected to use the reserve method of accounting for bad debts for income tax purposes substitute for excess profits tax purposes a deduction for debts which became worthless in whole or in part within the taxable year. This is desirable because the banks which elected to use the reserve method for income tax purposes beginning in 1947 have for the most part accumulated reserves that equal or approach the maximum allowable under the existing rulings. In view of this situation and because of the probability that losses from bad debts will be comparatively low during the excess profits tax years it is likely that the deductions under the reserve method will be abnormally low during the excess profits tax period. The deduction of such losses as they occur will provide a more equitable result."

Appendix D

In the
United States Court of Appeals
for the Fifth Circuit

Commissioner of Internal Revenue, *Petitioner,* vs. Mercantile National Bank at Dallas, *Respondent.*	No. 17,622 March 15, 1960.

Petition for Review of Decisions of the Tax Court of the United States (District of Texas).

Before CAMERON, JONES and BROWN, Circuit Judges.

JONES, Circuit Judge: The respondent is a National Banking Association at Dallas, Texas. Before us for review is a determination of the Tax Court as to the excess profits taxes payable by the Bank for the years 1951, 1952 and 1953. *Mercantile National Bank at Dallas v. Commissioner*, 30 T.C. 84. The facts are not in dispute nor are the factual inferences to be drawn from them. Since 1944 the Bank, with the Commissioner's approval, has used the reserve method of accounting for bad debts. Under this method the Bank set up, initially, a bad debt reserve and added to it, annually, further amounts. The amounts credited to the bad debt reserve account each

year were deducted in computing the Bank's normal tax and surtax. Debts determined to be worthless were charged to the bad debt reserve and bad debt recoveries were credited to the reserve, but these charges and credits were not used in computing normal tax and surtax although they might indirectly affect it because of the limitation placed upon the accumulated total of the reserve. See Mim. 6209, 1947-2 C.B. 26. Under the Excess Profits Tax Act of 1950,[1] banks using the bad debt reserve method were not permitted to deduct the amount allowable under such method for bad debts, but in lieu thereof were allowed to take a deduction for the bad debts which became worthless during the taxable year.[2]

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[1] 64 Stat. 1137 et seq.

[2] "The excess profits net income for any taxable year ending after June 30, 1950, shall be the normal tax net income, as defined in section 13(a)(2), for such year increased or decreased by the following adjustments:

"(1) Adjustments.—

* * *

"(G) Recoveries of Bad Debts.—There shall be excluded income attributable to the recovery of a bad debt if the deduction of such debt was allowable from gross income for any taxable year beginning before January 1, 1940, or beginning after December 31, 1945, and ending before July 1, 1950, or if such debt was properly charged to a reserve for bad debts during any such taxable year;

* * *

"(L) Bad Debts in Case of Banks.—In the case of a bank (as defined in Section 104) using the reserve method of accounting for bad debts, there shall be allowed, in lieu of the amount allowable under the reserve method for bad debts, a deduction for debts which became worthless within the taxable year, in whole or in part, within the meaning of section 23(k); * * *" 26 U.S.C.A. (I.R.C. 1939, as amended) § 433(a).

The statutory provision was supplemented by a regulation of the Commissioner which spelled out the method of effecting the adjustment between the normal-tax net income and excess profits net income of banks using the bad debt reserve method.

In its excess profits tax returns for the years involved the Bank computed its excess profits net income by adding to the normal tax net income the amounts allowable for the bad debt reserve increases for the respective years, and taking deductions for the amounts of the debts determined to be worthless during the several years. During these years the Bank had substantial recoveries of debts which had been charged in prior years to the bad debt reserve. The amounts of these recoveries were not included as income in the excess profits tax computations of the Bank. The Commissioner concluded that the excess

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[3] "The excess profits net income computed under section 433(a) for any taxable year ending after June 30, 1950, is the normal-tax net income increased or decreased by the adjustments provided in section 433(a)(1). * * *

"(1) In the case of a bank (as defined in section 104) using the reserve method of accounting for bad debts, section 433(a)(1)(L) requires an adjustment to normal-tax net income equal to the difference between (1) the amount of the deduction for additions to the reserve for bad debts allowed under section 23(k) (including, in the case of the taxable year in which the reserve is established, the deduction for the initial credit to the reserve) and (2) the amount that would have been allowable as a deduction under section 23(k) for bad debts for the taxable year if the bank did not use the reserve method of accounting for bad debts. The adjustment is effected by increasing normal-tax net income by the amount of the deduction allowed under section 23(k) for the additions to the bad debt reserve for the taxable year and by decreasing normal-tax net income by the amount of the deduction which would be allowable under section 23(k) for the debts which actually became worthless in the taxable year, in whole or in part." Treas. Reg. 130 § 40,433(a)(1), (a)(2).

profits net income should be increased by the amounts of the bad debt recoveries and deficiency assessments were made which were redetermined by the Tax Court and are before us for review.[4] The Tax Court, in sustaining the Bank's position, thus stated its reasons:

> "We agree with the petitioner [Bank] that the respondent [Commissioner] erred in making this adjustment. In enacting section 433(a), Congress has specifically, and in detail, provided for the method of computing excess profits net income. In subparagraph (L) it has specifically legislated with regard to the treatment of bad debts in the case of banks employing the reserve method. Neither in that subparagraph nor elsewhere in section 433(a) did Congress provide for the inclusion by such banks of recoveries of bad debts. We must assume that Congress, in specifically legislating with regard to banks employing the reserve method, completely expressed its intention as to the effect of bad debts and recoveries in the computation of their excess profits net income. Considering the precise detail provided by Congress for the computation of excess profits net income, we think that had it intended to implement subparagraph (L) by restoring to excess profits net income of a bank on the reserve method any income from recoveries of bad debts, it would have so provided. The Congressional committee reports regarding section 433 seem to indicate that subparagraph (L) spells out the extent of bad debt adjustments to be made in the case of banks on the reserve method in reaching the equitable result referred to in the Senate report: at least such reports do not indicate that any further

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[4] No review is sought by the Bank with respect to other questions which were decided against it by the Tax Court.

adjustment is to be made. Nor do the regulations promulgated under section 433(a) of the Code provide for any further adjustment." 30 T.C. 93-94.

The Commissioner attacks the Tax Court's decision as "a mere exercise in literalism and a perversion of the legislative intent." He urges that the decision is "contrary to the plain meaning and intent of the applicable statutory provisions and produces an injustice which was never intended by the Congress."

Taxpayers, including banks, not using the bad debt reserve method of accounting were entitled, for normal income tax purposes under the 1939 Internal Revenue Code, as amended, to take deductions for debts which became worthless during the tax year, and are required, subject to the "recovery exclusion" provisions, to include as taxable income the bad debt recoveries during the year of their receipt to the extent that a tax benefit was received during a prior year. 26 U.S.C.A. (I.R.C. 1939, as amended) §§ 22(b) (12), 23 (k)(1); *Merchants National Bank v. Commissioner*, 5th Cir., 1952, 199 F. 2d 657. Banks using the bad debt reserve method, in computing their normal tax income, were entitled to deduct the amount which, during the taxable year, was added to the bad debt reserve. Although the amount of the accumulated bad debt reserve is decreased by actual bad debt losses sustained and increased by bad debt recoveries, the losses and recoveries as such do not enter into the computation of normal tax income. For normal tax computation only the amount of the addition to the bad debt reserve is deductible even though that amount should be greatly exceeded by actual

bad debt losses. So also, for normal tax purposes, bad debt recoveries are not included as taxable income even though such recoveries should greatly exceed the addition to bad debt reserves.

The excess profits tax net income for the years here involved was the normal tax net income increased or decreased by the adjustments set forth in the statute. The adjustment, in the case of banks using the reserve method of accounting for bad debts, allows a deduction for debts becoming worthless instead of the amount of the addition to the bad debt reserve. The bad debt recoveries of such banks are not, therefore, to be included in their excess profits taxable income unless it appears that the Congress so intended as a corollary to the expressed provision requiring that the bad debt deduction should be the actual bad debt losses rather than the amount added to the bank's bad debt reserve. Such intent is not expressed in the language of Section 433(a)(1)(L), nor is such intent to be implied from the language of the statutory provision. In the courts of England it is the rule that, "If Parliament does not mean what it says it must say so." Herbert, Uncommon Law, 192. But such rule is not to control in construing acts of Congress. *Westinghouse Employees v. Westinghouse Electric Corporation*, 348 U.S. 437, 75 S. Ct. 488, 99 L.Ed. 510. Cf. Dissenting opinion *Commissioner v. Acker*, 361 U.S. 87, ... 80 Ct. .... 4 L.Ed. 2d 127. Aids to construction may be resorted to, it has been said, even where there is no ambiguity. *United States v. Korgan*, 7th Cir., 1956, 257 F. 2d 676, rev'd on other grounds, 354 U.S. 271, 77 S. Ct. 1099, 1 L.Ed. 2d 1337.

The reasons found in the legislative history for the enactment of the provision are substantially the same in the committee reports of the House of Representatives[5] and of the Senate.[6] In neither committee report is there a suggestion that banks using the reserve method of bad debt accounting should include bad debt recoveries as income. The discussion in the reports deals wholly with bad debt losses and not at all with bad debt recoveries. The Commissioner recognizes this, and so points to the congressional use of the word "equitable." Since taxpayers other than banks using the reserve method are required to include bad debt recoveries as well as deduct-

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[5] "For income tax purposes, banks have been permitted to use the reserve method of accounting for bad debts. The banks which elected to use this method, beginning in 1947, have for the most part accumulated reserves which equal or approach the maximum allowable under the existing rulings. The fact that the reserves have reached or approached the allowable maximum, plus the probability that losses from bad debts will be abnormally low during the excess profits tax years, means that the deduction in the excess profits tax period will be comparatively low. To permit an equitable comparison between the base-period net income and the income of the excess profits tax years, the bill permits banks using the reserve method of accounting for bad debts to claim a deduction for the purpose of determining excess profits tax net income on the basis of debts which become worthless in whole or in part during the taxable year." H.R. Rep. No. 3142, 81st Cong., 2d Sess., p. 14, 1951-1 C.B. 187, 196.

[6] "Banks which have elected to use the reserve method of accounting for bad debts for income tax purposes substitute for excess profits tax purposes a deduction for debts which became worthless in whole or in part within the taxable year. This is desirable because the banks which elected to use the reserve method for income tax purposes beginning in 1947 have for the most part accumulated reserves that equal or approach the maximum allowable under the existing rulings. In view of this situation and because of the probability that losses from bad debts will be comparatively low during the excess profits tax years it is likely that the deductions under the reserve method will be abnormally low during the excess profits tax period. The deduction of such losses as they occur will provide a more equitable result." S. Rep. No. 2679, 81st Cong., 2d Sess., p. 15, 1951-1 C.B. 240, 250.

ing bad-debt losses, the Government insists it would be inequitable to allow such banks to omit the recoveries from their excess profit tax income. We are reminded by the Government that "A desire for equality among taxpayers is to be attributed to Congress rather than the reverse." *Colgate-Palmolive-Peet Co. v. United States*, 320 U. S. 422, 64 S. Ct. 227, 88 L. Ed. 143, reh. den. 320 U. S. 810, 64 S. Ct. 423, 88 L. Ed. 493. However, the attributing to Congress a desire for equality will not supply a congressional intent that cannot be made to appear from either the legislation or the legislative history of a controlling statute.

"Equitable" does not necessarily mean exact equality. It means fair, just, and impartial. *Pearce v. Wisdom*, 175 Ga. 663, 165 S. E. 574, *Hackett v. Equitable Life Assurance Society*, 50 App. Div. 266, 63 N.Y.S. 1092, *Taylor v. School District*, 128 Neb. 437, 259 N.W. 168, *Burlington Transportation Co. v. Iowa State Commerce Commission*, 230 Iowa 570, 298 N. W. 631; *United States v. 11360 Acres of Land*, D.C.N.D.Cal. 1945, 62 F. Supp. 968. The committee report shows the desire to create an equitable result, that is, one which would be fair, just and reasonable for banks using the reserve method and not necessarily for other taxpayers. Inequalities in Federal taxation are not unknown. The Revenue Act of 1948 providing for joint returns by husbands and wives made for equality of the tax burden upon married couples throughout the country but discriminated against bachelors and spinsters. So also insurance companies are taxed under separate provisions of the Internal Revenue Code and some kinds of insurance companies are taxed

differently than others. Whether it is fair, just, reasonable, and equitable that banks using the bad debt reserve method of accounting should, for excess profit tax computation, deduct actual bad debt losses rather than the reserve allowance without including bad debt recoveries is to be determined by the Congress; not by the Commissioner or the Courts. We think the determination has been made by Congress and we affirm the decision of the Tax Court so holding.

There is nothing in the statute or in the committee reports which, expressly or by necessary implication authorizes a determination such as the Commissioner urges upon us. There is no ambiguity in the applicable statute. If it tends to give a benefit to a particular class of taxpayers, we cannot say that Congress did not so intend. As said by the Supreme Court, "After all, Congress expresses its purpose by words. It is for us to ascertain —neither to add nor subtract, neither to delete nor to distort." 62 Cases of *Jam v. United States*, 340 U. S. 593, 71 S. Ct. 515, 95 L. Ed. 566. Whether Section 433(a)(1)(L) would be beneficial or not to a particular bank would depend upon its own bad debt experience during the taxable year.

The Government urges that the Tax Court's decision construes Section 433(a)(1)(L) as conflicting with and annulling the effect of Section 433(a)(1)(G). We cannot agree. This latter section, considered in context, relates to taxpayers who do not use the bad debt reserve method of accounting and so are required to include bad debt recoveries in the computation of normal tax income. The section permits such taxpayers to exclude certain bad

debt recoveries from excess profits income. It is not a provision which requires the inclusion of bad debt recoveries by any taxpayer.

It is by no means certain that the question we decide was considered by the framers of the statute. It may be that the statute gives an undeserved benefit to a particular class of taxpayers. Commenting upon such problems, the Supreme Court has said:

> "Courts have sometimes exercised a high degree of ingenuity in the effort to find justification for wrenching from the words of a statute a meaning which literally they did not bear in order to escape consequences thought to be absurd or to entail great hardship. But an application of the principle so nearly approaches the boundary between the exercise of the judicial power and that of the legislative power as to call rather for great caution and circumspection in order to avoid usurpation of the latter. Monson v. Chester, 22 Pick. 385, 387. It is not enough merely that hard and objectionable or absurd consequences, which probably were not within the contemplation of the framers, are produced by an act of legislation. Laws enacted with good intention, when put to the test, frequently, and to the surprise of the lawmaker himself, turn out to be mischievous, absurd or otherwise objectionable. But in such case the remedy lies with the law making authority, and not with the courts." *Crooks v. Harrelson*, 282 U.S. 55, 60, 51 S. Ct. 49, 75 L. Ed. 156; See *St. Louis Company v. United States*, 3rd Cir., 1956, 237 F. 2d 151.

We can no more grant relief to the Government from hardships than we could to a taxpayer. The decision of the Tax Court is

AFFIRMED.